

Monetary policy, financial stability, and “leaning against the wind”

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Outline

- Flexible inflation targeting
- Financial stability
- Leaning against the wind
- Swedish monetary policy in the last few years
- Household debt in Sweden
- The Riksbank’s framework for monetary policy and household debt
- Lowflation/deflation and debt
- Conclusion about leaning against the wind

Flexible inflation targeting

- Strict inflation targeting
 - Only objective: Stabilizing inflation around inflation target
- Flexible inflation targeting
 - Stabilize inflation around inflation target *and* resource utilization around long-run sustainable rate (unemployment around long-run sustainable rate)

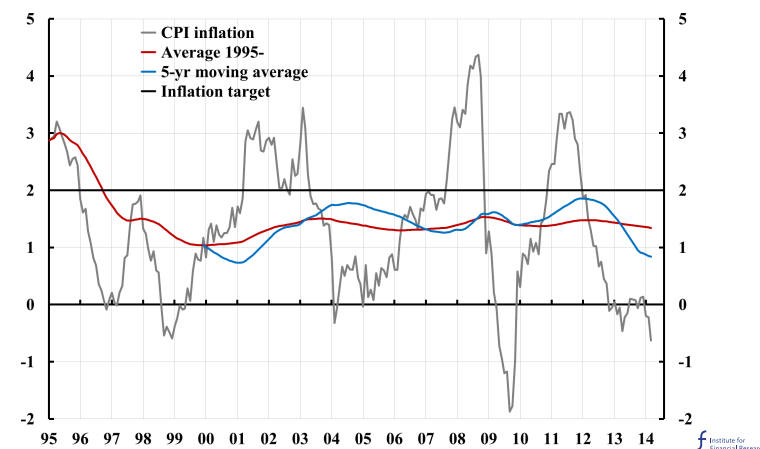
Financial stability

- Definition: The financial system can achieve its 3 main functions (transform saving into financing, allow risk management, submit payments) with sufficient **resilience** against disturbances that threaten the main functions
- Resilience requires sufficient capital, buffers, liquidity, net stable funding...
- Monetary policy cannot achieve financial stability
- Financial stability requires micro- and macroprudential policy

Leaning against the wind

- Tighter monetary policy than justified by stabilizing inflation and unemployment
- Dampen asset-price and credit booms, moderate threats to financial stability
- Presumes (Smets 2013):
 - (1) Macroprudential instruments or policies are ineffective
 - (2) A higher policy rate has a significant negative impact on threats to financial stability
- My view:
 - (1) varies from country to country
 - (2) has little theoretical and empirical support, although the latter may vary depending on the structure of the financial sector (competitive/oligopolistic, shadow banking...)

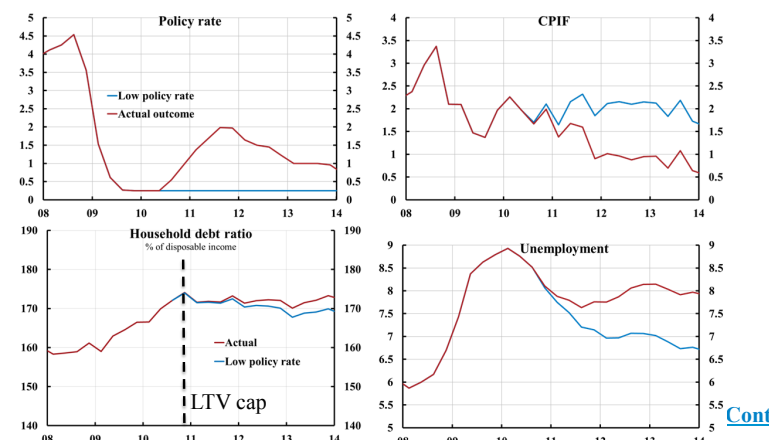
Target achievement: Average inflation significantly below target



Sweden: Monetary policy outcome in recent years

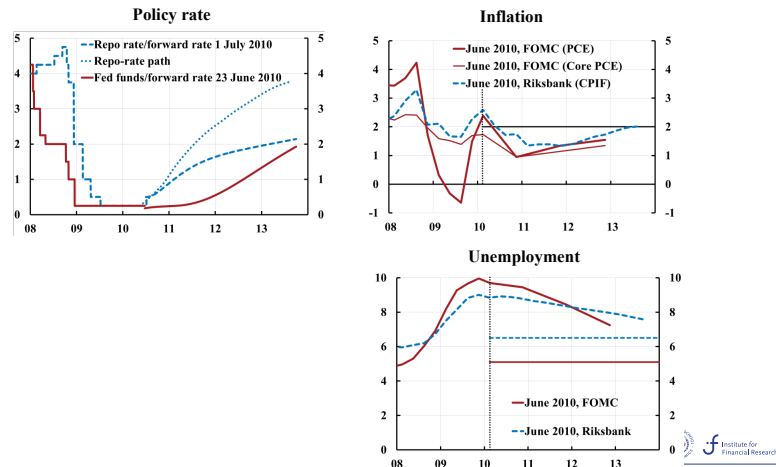
- Inflation is far below the target
- Unemployment is far above a long-run sustainable rate
- Inflation below expectations has increased household real debt

Policy-rate increases from summer of 2010 have led to inflation below target and higher unemployment (and probably a higher debt ratio)



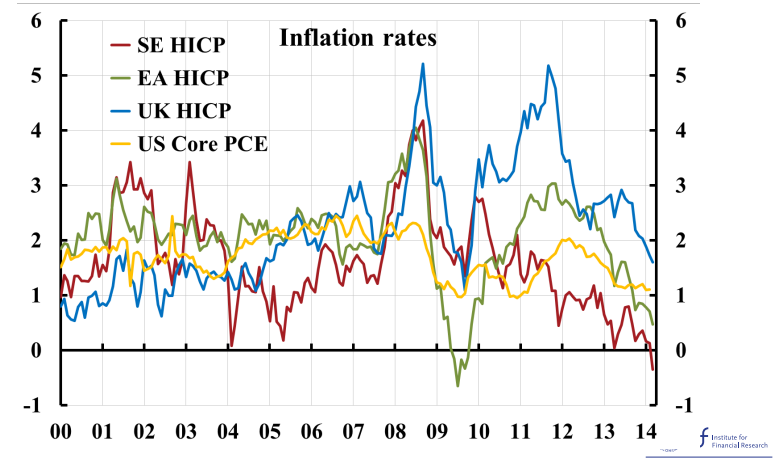
Source: Svensson (2013), "Unemployment and monetary policy – update for the year 2013,"
 Svensson (2013), "Leaning against the wind increase (not reduces) the household debt-to-GDP ratio", Swedish House
 posts on larscosvensson.se. Swedish House of Finance 8

Fed and Riksbank, June/July 2010 Similar forecasts, very different policies

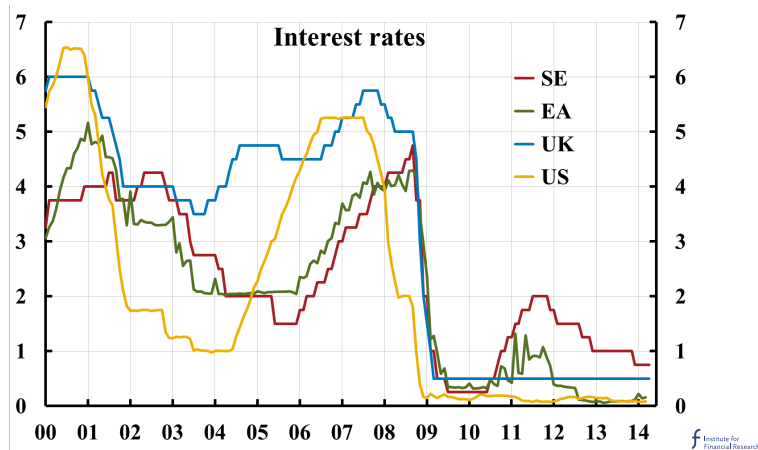


Svensson (2011), "Practical Monetary Policy: Examples from Sweden and the United," *Brookings Papers on Economic Activity*, Fall 2011, 289-332.

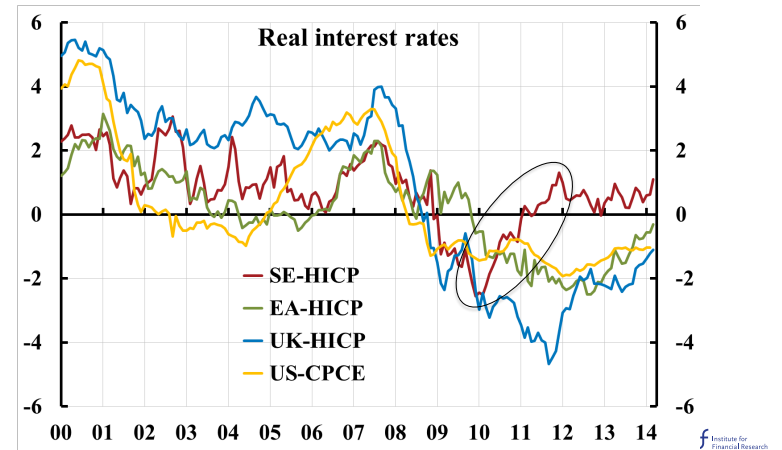
Inflation in Sweden, euro area, UK, and US



Policy rates in Sweden, UK, and US; Eonia rate in euro area



Real policy rate in Sweden, UK, and US, real Eonia rate in euro area



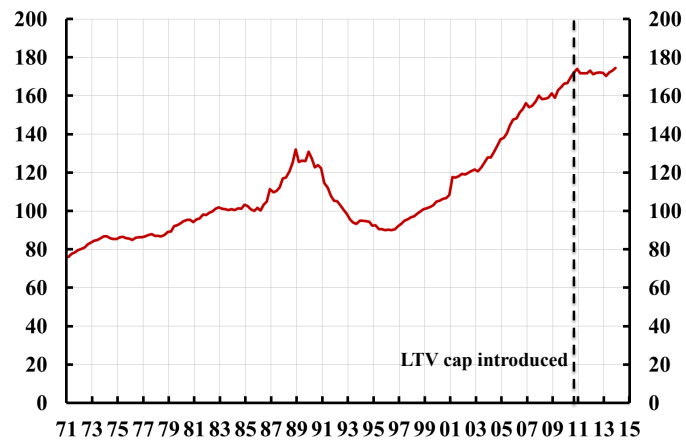
Why?

- Household debt is high relative to disposable income

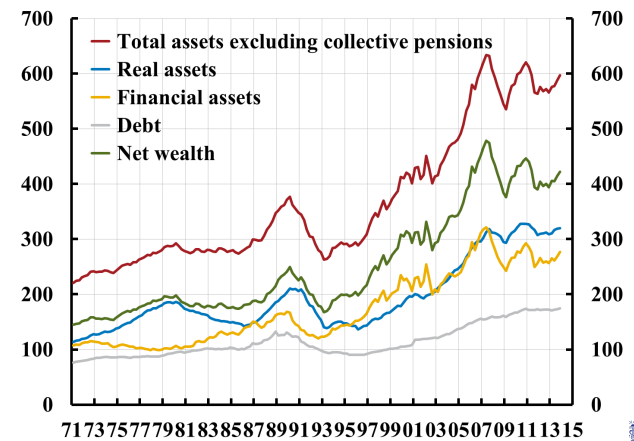
Why?

- Household debt is high relative to disposable income
- But debt is normal relative to assets

Household debt-to-income ratio
(% of disposable income)



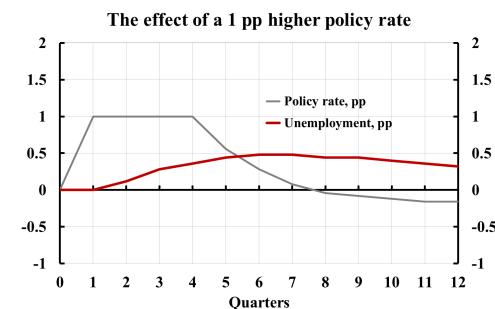
Household debt and assets (excluding collective pensions), % of disposable income



What is the problem?

- Household debt is high relative to disposable income
- But debt is normal relative to assets
- Housing prices are in line with fundamentals (disposable income, mortgage rates, tax changes, urbanization, construction...)
- High debt mainly with borrowers with the best capacity to manage them (high income, high education, safe jobs, large assets) (Hedborg Government Commission of Inquiry)
- Household repayment capacity is good (FSA)
- Household resilience to disturbances in the form of mortgage rate increases, housing price falls, and income falls due to unemployment is good (FSA)
- Is there really a problem?
- What is the Riksbank's case for leaning against the wind?

Cost of 1 pp higher policy rate: 0.5 pp higher unemployment rate



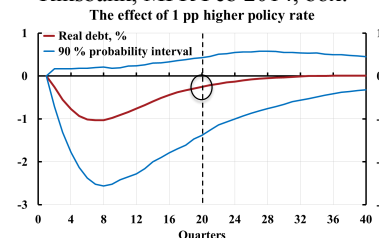
Source: MPR July 2013, chapt. 2; Svensson, posts on Ekonomistas and larseosvensson.se, March 31, 2014.

Riksbank's case for leaning against the wind

- Higher debt could imply higher *probability* of a future crisis, or a *deeper* crisis if it occurs
- Hence, a tradeoff between tighter policy now and worse expected outcome in the future
- A higher policy rate now leads to worse outcome now but better expected outcome in the future (insurance premium)
- Is that true?
- The answer can be found in the Riksbank's own boxes in MPR July 2013 and February 2014, plus Schularick and Taylor (2012) and Flodén (2014)

Benefit of 1 pp higher policy rate: Lower probability of a crisis?

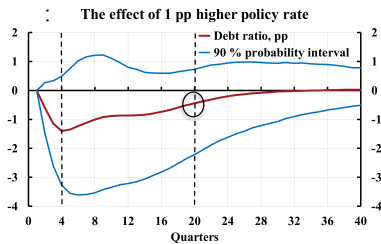
- Schularick and Taylor (2012):
5 % lower real debt in 5 yrs
implies 0.4 pp lower probability
of crisis
(average probability of crises
about 4 %)
- Riksbank, MPR Feb 2014, box:
The effect of 1 pp higher policy rate
- 1 pp higher policy rate leads to 0.25 %
lower real debt in 5 years
- Lowers probability of crises by
 $0.25 \times 0.4 / 5 = 0.02$ pp
- Riksbank crisis scenario (MPR July
2013, box):
5 pp higher unemployment in crisis
- Benefit:
Expected lower future unemployment:
 $0,0002 \times 5 = 0.001$ pp
- Compare to cost: 0.5 pp higher
unemployment rate



Source: Svensson, post on Ekonomistas and larseosvensson.se, March 31, 2014.

Benefit of 1 pp higher policy rate: Smaller increase in unemployment if crisis?

- Flodén (2014): 1 pp lower debt ratio may imply 0.02 pp smaller increase in unemployment rate in crisis
- Riksbank, MPR Feb 2014, box:
 - 1 pp higher policy rate leads to 0.44 pp lower debt ratio in 5 yrs
 - Smaller increase in unemployment in crisis: $0.44 * 0.02 = 0.009$ pp
 - With probability of crisis as high as 10 %, divide by 10: 0.0009 pp (Shularick & Taylor: 4 %)
 - Compare with 0.5 pp increase in unemployment



Source: Svensson, posts on Ekonomistas and larseosvensson.se, March 31, 2014.

Summarize cost and benefit of 1 pp higher policy rate

Table 1. Cost and benefit in unemployment of 1 percentage point higher policy rate during 4 quarters

Cost: Higher unemployment during the next few years, percentage points	0.5
Benefit: Lower expected future unemployment, percentage point	
1. Because of lower probability of a crisis	0.001
2. Because of a smaller increase in unemployment in a crisis	0.0009
Total benefit, percentage points	0.0019
Total benefit as a share of cost, percent	0.38

- Riksbank case does not stand up to scrutiny

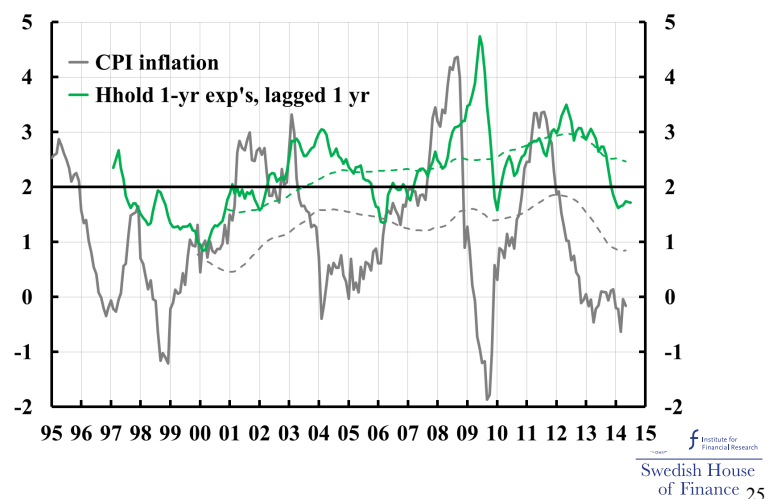
Inflation below target causes real effects

- Inflation expectations anchored at target
- Lower average inflation than expected causes real effects
- Higher unemployment
- Higher *real* debt for households ...
- ... and higher LTV ratios, lower net wealth and net wealth to assets ...
- ... and higher debt ratio

Lowflation/deflation and debt: Increased real debt

- Chair Yellen: “[W]ith longer-term inflation expectations anchored near 2 percent in recent years, persistent inflation well below this expected value increases the real burden of debt for households and firms, which may put a drag on economic activity.”
- Governor Ingves, in reply to a question if low inflation increases indebtedness: “Interest rates are low and then it is easy to borrow... But in this context, the inflation rate is not a particularly significant issue.”

CPI inflation and household inflation expectations



Leaning against the wind and household debt

- "Leaning against the wind" is counter-productive in Sweden
- Inflation on target, stable growth, and lowest long-run sustainable unemployment is monetary policy's best contribution to the debt issue (at least in Sweden)
- Financial stability and any problems with debt are better handled with other means: macro- and microprudential tools (LTV cap, higher capital, risk weights...), taxes, deduction rules...

The real value of an SEK 1 million loan taken out in Nov 2011, actual and for 2 percent inflation

Figure 7. The real value of a SEK 1 million loan taken out in November 2011, actual and for 2 percent inflation.

